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Long-run Ranges
Donald L. Kohn

I will begin with a few points from the long-run scenario section of the bluebook. These exercises are, at best, only indicative of the potential outcomes, but they may be useful in illustrating general tendencies and results as you think about policy alternatives.

First, judging from the staff projections and model simulations, the current level of the federal funds rate is slightly restrictive, and will become more so in coming years as inflation decreases and additional fiscal restraint kicks in. This is evident in the small gap that opens up between potential and actual output this year in the baseline strategy, and in the decline in the funds rate in subsequent years required to keep the gap from getting wider. By the standards of past variations in the federal funds rate, the adjustment is not that large. Even under the easier strategy, which eliminates monetary restraint and also offsets fiscal policy, the funds rate moves down only to 4-3/4 percent, remaining well above the lowest levels reached in the recent period of sluggish expansion. Even if fiscal policy were somewhat less restrictive, reductions in the federal funds rate probably still would be needed, though when they might have to start would depend importantly on the behavior of the bond market, as Mr. Simpson illustrated.

Second, with the discussion of price-stability goals for monetary policy again coming to the fore, it may be useful to review the output losses that may be associated with that endeavor. The bluebook simulations, of course, embody the conventional accelerationist Phillips curve model, and calculations like these probably will be used in any public debate about changing the goals of the Federal Reserve. In sum, the bluebook simulation that gets to the neighborhood of price stability shortly after the year 2000 requires 3 percentage point years of more unemployment than the path of output in the easier strategy that holds inflation at around its current level. To be sure, the model does not allow for a credibility effect of announcing and committing publicly to such a goal--that is, the sacrifice ratio does not depend on the strategy followed. But it is, in fact, difficult to find such a credibility effect empirically for the United States or other countries. The model also does not allow for favorable feedbacks of declining inflation on the level or trend in productivity. Using the very generous estimate of the Rudebusch-Wilcox paper, and phasing in the productivity gains as the disinflation occurs, the present value of the net output losses from disinflation is recovered by only a few years after virtual price stability is reached in 2000. Others have found favorable, but less extreme results for productivity gains; if the effect is about one-tenth the Rudebusch-Wilcox result, it would take about 19 years from now to recoup the cumulative lost output. Some researchers, of course, have been unable to pinpoint the size of any effect.

Third, the exercises subjecting the baseline forecast to supply and demand shocks remind us of the risks inherent in using a nominal federal funds rate as the policy instrument. When holding to a predetermined funds rate path in the face of such shocks, instabilities begin small, but ultimately gather increasing force as changes in inflation expectations feed back on real rates, which feed back on the economy and inflation. The equilibrium real rate may not change by a lot in response to a shock; the two illustrations in the bluebook require adjustments of only 1/4 to 1/2 percentage point. Nonetheless, in the face of such a shock, to get the same inflation outcome by a given time, the lags in the effects of monetary policy mean that a much larger funds rate adjustment is needed initially than ultimately. Moreover, recognizing that the state of the world has changed will take a while, and the longer the needed adjustment is delayed, the larger is the required initial rate movement. This is the lesson from the United States in the late-1970s, and apparently from Japan in the mid-1990s.

At this meeting, you are faced with the task of reconsidering the annual ranges for money and debt for 1995 and setting provisional ranges for 1996. Staff projections and alternative ranges for 1995 are given in a table on page 12 of the bluebook. Overall credit flows have been a little stronger than anticipated early in the year, reflecting importantly the financing of inventory investment. Moreover, a remarkably high proportion of credit flows has gone through depositories, as borrowers continued to favor debt that was short-term or repriced frequently until the recent sharp decline in bond yields. As a consequence, although debt growth is only a little above the middle of its range, M3 is appreciably over the upper end of its range. With market rates coming down, and yields on M2 assets responding sluggishly as usual, savers have favored M2 assets, in effect helping to fund the re-intermediation of credit. M2, as a consequence, is running in the upper portion of its range.

Over the balance of this year, we see credit growth slowing some--bringing this measure to around the middle of its current range --and more of it being financed in longer-term markets. As a consequence, M3 growth should slow substantially, but not enough to put it within its current range. M2 growth on average over the second half should look much like the first half, leaving this aggregate within its range. We are projecting that the very recent surge in M2 will taper off, partly as rates on money funds and other M2 assets come more into line with the lower market rates. Still, the possibility that M2 could run above its range, especially if the Committee eases the stance of policy in coming months, can't be ruled out.

Even so, only the M3 range would seem to require consideration of a possible adjustment at this meeting. The Committee could leave the range unchanged and simply state that a temporary surge in bank lending was expected to push actual growth above the range this year. However, the staff believes that the weakness in depository credit and M3 growth over the previous four years was the outlier. Until the thrift and bank crises of the late 1980s, M3 generally had grown at least as fast as M2, and with depository institutions now healthier, faster M3 growth relative to income and to M2 now seems a reasonable expectation. In this case, the Committee should consider adjusting its M3 range upward; an increase of 2 percentage points--to 2 to 6 percent--would seem to represent a reasonable relationship with the M2 range and to have a reasonable chance of being high enough to encompass M3 growth for the year. Such a decision could be explained as a technical adjustment to take account of the return to more normal patterns of intermediation and M3 velocity, without any implications for the thrust of monetary policy. Indeed, the February Humphrey-Hawkins Report warned that for these reasons, an increase in the 1995 M3 range might prove necessary.

Staff projections and alternative sets of ranges for 1996 are given on page 17 of the bluebook. Under the interest rates and nominal income of the Greenbook forecast, we would expect in 1996 basically a continuation of the trends of the second half of this year.

M2 growth would come in a little higher in 1996 than in 1995, buoyed in part by a strengthening in nominal income and the assumed drop in interest rates next year, while debt and M3 would slow further; M3 would still remain strong by the standards of earlier in the 1990s as depositories continue to capture a substantial share of total lending.

In Julys of recent years, the Committee generally has chosen simply to carryover whatever ranges it has chosen for the current year as provisional ranges for the next year. This has been attractive because of the uncertainties about evolving money-income relationships, and because the ranges were already low enough that there was no scope to lower them further to send a message about the Committee's intent to seek price stability over time. Given the staff projections, this strategy would certainly work for 1996, especially if you chose to adjust the M3 range higher for 1995.

You may have noticed that the staff discussion and forecast of broad money and credit was a little more straightforward than in most bluebooks over recent years--that is, there were fewer mentions of persistent shifts in asset demands and special factors. This raises two questions: Is the targeting exercise more meaningful? Even if relying on target ranges is still dubious, is the behavior of the aggregates conveying any useful information about the underlying economic situation?

To be sure the <u>growth</u> of M2 has come much more in line with results from traditional specifications of its demand over the last two years as the lure of bond mutual funds faded with the backup in market rates last year. However, the <u>level</u> of this aggregate remains well below that predicted by these specifications, and M2 growth in the second quarter was appreciably in excess of the prediction of the standard model. This latter miss likely reflects the unusual behavior of intermediate- and long-term rates; the standard model proxies the returns on alternative assets with a three-month Treasury bill rate--not a good choice when long-and short-term rates fail to move in their traditional alignment. These results suggest that our understanding of M2 demand is still fragile. The recent experience may suggest a greater sensitivity of M2 demand to long-term rates, and associated changes in its cyclical performance. In other words, it seems too early to tell whether we're back on a well-specified and useful demand curve. Even if we are, it is well to remember that the monetary aggregates, even in their well-behaved episodes--provided only rough guideposts for policy, and had to be interpreted in the context of a broad array of other information in the economy. It was the Committee's frustration with trying to make sense out of annual growth ranges for M2 that led to the P* exercise, which looked to signals from the longer-term trends in M2.

Nonetheless, the turnaround in broad money and the pickup in private and total debt growth this year may be indicative of the substantial easing of financial conditions that have occurred this year through movements in market interest rates. Credit is flowing freely and the liquid assets of the public are rising rapidly. These circumstances do not seem to suggest unusual or severe financial constraints on spending.

The exceptions to this picture of relative strength in flows are M1, reserves, and the monetary base. It is true that we're having to withdraw reserves to keep the funds rate where it is. In the last month this has been a result of the bookkeeping of banks, who have instituted NOW account sweeps to reduce the reserve requirement tax. But we were draining reserves earlier this year as well. At the configuration of interest rates and income flows in the first half, people don't want to hold as much M1. This has been largely a function of the lagged effects of the rise in interest rates last year. We expect these effects to abate; without sweeps we would see some growth in M1 and reserves last month and going forward--but very slow.

More fundamentally, deregulation and changes in payment technologies have eroded the differences between transactions and nontransaction assets, making M1 demand more dependent on interest rate relationships. As a consequence, growth of this aggregate now swings over a wider range and its velocity varies more than before for the same changes in short-term interest rates; in other words, you can't judge underlying financial conditions using standards for M1 growth derived from the 1960s and 1970s. The extraordinarily rapid expansion of M1 in 1992 and 1993 went along with a decision to go to, and stay with, what seemed by other measures a moderately expansionary policy--less expansionary than in many recessions--that the FOMC judged appropriate to the circumstances. Slow growth and contraction of M1 in 1994 and 1995 does appear consistent with the move to modestly restrictive stance of policy. The question is whether that stance is appropriate to the current circumstances--but the Chairman will quickly remind me that that's the subject of another part of the meeting.

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Short-run Policy
Donald L. Kohn

As noted in the discussion of long-run scenarios, policy may well be positioned a bit to the restrictive side at this point. This can be seen not only in the results of the staff forecast and model baseline simulation with its downward tilt to inflation, but also in the level of the real federal funds rate relative to its historical averages, in the read outs from various "policy rules" keyed to output and inflation or nominal GDP--which tend to produce federal funds rates below 6 percent--and even perhaps in the behavior of the monetary aggregates--at least the narrower ones. Especially if federal deficit reduction unfolds along anything like the path assumed by the staff, a decrease in nominal and real funds rates would seem to be needed at some point over the next few years, unless the Committee were intent on making considerable progress toward price stability.

Implied in the staff forecast and the alternative scenarios is that the current funds rate is about 1/2 to 3/4 of a percentage point above its natural rate--though this is undoubtedly putting too fine a point on an ambiguous measure. Nonetheless, this estimate does seem to be consistent with readings from financial markets. Those markets have built in an easing by year-end of something like this magnitude. Judging from the stock market, a decline of this size is seen as sufficient to foster the earnings growth that would be associated with continued good economic expansion. As Peter noted, markets do see some possibility of ease at this meeting, and no action could be associated with a modest edging up in rates. Over a longer stretch, a failure to ratify the expected decline would cause longer-term rates to back up more, at least in real terms, reversing some, but by no means a large portion, of the downward movement registered since last winter.

But that backing up helps to keep the disinflation process going in the staff forecast. Market expectations for inflation are at best difficult to read, but the overall term structure of interest rates retains an appreciable upward tilt, and many outside forecasts as well as survey results seem to suggest widespread expectations for flat or even slightly higher inflation over coming years. An argument for maintaining the current stance of policy would be that in building in rate declines, the market has misread your intentions for inflation; keeping the funds rate unchanged at this time increases the odds on some disinflation and would send another signal to markets that the Federal Reserve takes seriously its stated goal of making progress toward price stability over time.

Keeping policy unchanged might also be preferred if the Committee saw appreciable odds on upside risk to the staff forecast, say from the drop in market interest rates this year. To be sure, that decline can be seen as largely an endogenous response to to a weaker-than-expected economy. But markets may have over-reacted, especially since they may have been encouraged by some exogenous factors, including various testimonies and other public pronouncements from the Federal Reserve, as well as by firmer expectations of further fiscal consolidation that is not yet assured. With markets unlikely to respond strongly to an unchanged funds rate, and with the most recent data perhaps ameliorating concerns about the extent of the downward impetus to the economy, the Committee might view the costs as relatively small of awaiting additional information to judge the depth and persistence of the current slowdown and the response of aggregate demand to the more accommodative financial market conditions now in place.

Nonetheless, although inflation may not be on a downward track in the eyes of outside observers, it also is much less likely to strengthen than it seemed to be when the Committee last tightened--and this improvement in the inflation outlook may argue for a near-term adjustment in the stance of policy. In retrospect, the tightening last February perhaps can viewed as an insurance policy against building inflation pressures, which is less needed now. The slowing in the economy since then has been considerably more pronounced than anticipated, and the staff as well as many others have revised down expected inflation while also lowering the expected path for the federal funds rate. Committee members themselves have reduced projected growth for 1995 by almost a percentage point, and increased the anticipated unemployment rate at the end of the year to somewhere in the vicinity of the natural rate. With pressures on resources lessened, the risk of accelerating inflation would seem to have been greatly reduced, and the Committee might be able to decrease the degree of monetary restraint at least a little without risking adverse movements in actual or expected inflation.

An inclination in this regard would be reinforced to the extent the Committee did not place a high priority on fostering a continuing reduction in inflation rates in the immediate future. A number of you have expressed a preference over the years for a strategy that would attain price stability over time by leaning particularly hard against upticks in inflation to cap the rate at lower levels in each cyclical expansion--that is, an asymmetrical reaction function. Inherent in this strategy is not necessarily seeking deliberately to impose a persistent output gap, especially once inflation had stabilized around low levels. If the Committee were to follow this strategy, with the economy now moving into line with its potential, it would seem at this time to call for a more neutral policy. Such a policy adjustment would better assure that the economy grew along its potential in 1996.

Easing at this time, to be sure, would increase the odds on needing to reverse course once again later this year. If the Committee saw the chances of this occurring as quite large--that is, if you didn't think the federal funds rate was fundamentally too high--easing and then tightening just to react to incoming data would seem to risk unnecessarily confusing the markets about your intentions and your assessment of the current situation. But easing because you thought rates were in fact basically too high, and being prepared later to reverse should data come in to cause you to revise your assessment, would seem entirely appropriate and, in the event, readily explainable in the context of that new information. In particular, if you were concerned that the balance of risks was tilted toward a weaker economy, that it might take time to recognize developing adverse shocks, and that timely adjustments to policy might in these circumstances be difficult, some easing now might help to avoid the pitfalls of holding fixed the nominal funds rate in the face of shifts in supply or demand.

If a forward-looking monetary policy is successful in damping the amplitude of cycles in business activity and in interest rates, "mid-course corrections" of relatively small size may become more common. But so far monetary policy has tended to move in one direction in relatively long sequences, and, as a consequence, markets are likely to project further rate reductions following any easing action. Market reactions may be shaped by the words you use to describe and explain the action--in today's announcement and in the Humphrey-Hawkins testimony--but only to a limited extent. Instead markets are likely to read the action itself quite closely. In that regard, a 50 basis point cut in the funds rate might be seen as connoting that the Federal Reserve saw significant risks to economic expansion and current short-term rates as appreciably above appropriate levels. The resulting significant reduction in real interest rates would be desirable if the Committee indeed saw the situation in that light.

A 25 basis point cut would leave also a distinct impression that more was coming, perhaps even more promptly, promoting speculation almost immediately on when. Still, the market reaction might well be smaller than with 50 basis points. Unlike February 1994, a policy reversal at this meeting would not be occurring in the context of public statements and analysis that appreciable further changes in rates were likely to be necessary to achieve the System's objectives.